Lack of Access to Small Business Development Capital

By Meramec Regional Planning Commission, October 6, 2010

Missouri's economy is dependent upon the success of its small businesses. Nationwide, small businesses provide jobs for over half of the private workforce. Small businesses, likewise, are dependent upon access to capital for start-up and expansion. State and federal loans and grants—such as the Economic Development Administration Revolving Loan Fund grant and the USDA Rural Development Intermediary Relending Program loan—are valuable tools for financing these small business needs. However, to access the grants and loans, lending agencies must match federal monies. These matching funds are very difficult to obtain, especially in an already struggling economy.

The missed opportunity lies in the fact that, because of this lack of matching funds, many federal dollars are not being used to benefit small businesses in Missouri. For example, the Meramec Regional Planning Commission and the Meramec Regional Development Corporation recently experienced this problem when trying to recapitalize both the EDA Revolving Loan Fund and the USDA RD Intermediary Relending Program funds. Several months were spent working to raise match needed to apply for these grants/loans resulting in a total donated match of $43,500. Many entities that would normally commit to matching funds were unable to do so, due to the economic downturn. They used the $43,500 to match a smaller IRP fund. Program funds that leverage local match by a three-to-one or four-to-one ratio were left on the table to be accessed by other states.

Nationally, a host of federal agencies invest in business loan funds that are managed by state, regional and local agencies, including many of the nation's 520 regional planning and development organizations. According to NADCO.org, there are about 15 small business revolving loan funds across Missouri that are administered by regional planning commissions or not-for-profits. Most of these programs operate in a similar fashion and provide an existing structure for access to capital. The need lies in the fact that these agencies often do not have the match to leverage the grant/loan funds.

Providing a pool of funds that may be accessed by public business loan fund administrators for use as match will allow additional access to capital. This, in return, will result in retention and expansion of Missouri's existing small businesses, new businesses start-ups, and business attraction—and may be accomplished through the use of existing programs, or similar versions of them. This access to capital will assist Missouri in meeting its goals of entrepreneurial development, existing business retention/expansion, business climate improvements and business recruitment/attraction, among others.

Significance of the Problem:

Small businesses, especially in rural areas, are struggling. Many people are still out of jobs and opportunities for small businesses to access capital continue to dwindle. The current unemployment rate in Missouri is 9.6 percent, nearly the same as last year.

Nationally, small businesses have experienced major difficulties since the economic downturn began in 2006. According to *The Small Business Economy: A Report to the President* by the U.S. Small Business Administration Office of Advocacy, in 2007-08 some nongovernmental surveys found small firms expressing less willingness to expand, hire new workers, invest in new plant and equipment, or borrow money, at least in the near term. In particular, construction, an industry dominated by small firms, was hurting, having lost 682,000 jobs in 2008. The report further summarizes several of the current challenges faced by small firms, including access to capital, retaining a quality work force and global competition, among others. It also states that, "Small firms also make important contributions to the economy through innovations and the creation of jobs, enterprises, and entire new industries. In sum, small firms struggled mightily in the recessionary economy of 2008—and if the past is an indication, they will likely help lead the economic recovery."

We are now seeing a willingness on the part of local small businesses to work toward recovery by expanding, hiring workers, and/or investing in new plants or equipment. Banks are also ready to make investments in these small businesses, but are often looking for shared risk. In order to do this, lending agencies must be prepared to provide low-interest, long-term loans to these small businesses.

By way of examples, the loans made by the Meramec Regional Planning Commission and the Meramec Regional Development Corporation are loans made in partnership with banks, designed to offset the risk for the local lender, therefore allowing them to participate on projects that they may normally pass up. Since their inception in 1985 and 2006 the MRPC RLF and IRP have loaned $3.7 million. These loans generated $16.9 million in private investment and created/retained almost 890 jobs. These loans represent small businesses that may have never opened, may have had to close, or may have moved to another state, had the loans not been available. These numbers multiply many times over when the entire state's public business loan funds are considered.

Validating the Problem

According to the Small Business Administration, nearly 45,000 businesses close each month. Predicted record numbers of business failures, closures and bankruptcy in the coming years will occur due to declining consumer confidence, massive layoffs, credit constraints and foreclosures. According to the article, *Why Businesses Fail, by Christine Janklow* of WebCPA, "Proactive positioning can make all the difference between survival and demise." Ms. Janklow offers up five reasons for business failure—among them, the lack of capital.

According to MERIC, current Missouri employment information indicates that over 250,000 Missourians are looking for work. Median household incomes are slightly lower than those of 1996. Missouri's projected growth shows that, if something is not done, it can stand to miss out on around 350,000 potential jobs in the next 10 years.

A joint report of the National Association of Development Organizations (NADO) Research Foundation and the Development District Association of Appalachia states, "The key to public business loan funds capitalized with federal funds is that they are designed to complement private sector leaders and investors. Most importantly, they provide the gap financing and seed capital to make these deals a reality in underserved and distressed areas. Without the portfolio of federal loan funds, most local businesses and entrepreneurs would lack the necessary access to affordable, dependable and flexible capital in impoverished regions."

Access to capital can be a major factor in business recruitment, because companies are looking for a quality business climate in which to locate. They want to know that local and state incentives and business assistance will benefit them initially, as well as any future needs they may have. Since a major objective of most public business loan funds is job creation, these funds are an incremental part of any strategic effort that Missouri should implement to improve the state's overall economic picture. Also, any additional monies—including federal grants/loans—that can be brought into the state will multiply those local dollars many times over.

Best Practices

Recent studies of public business loan funds indicate that they often manage sizable portfolios. In its report on Public Sector Business Loan Funds, the National Association of Development Organizations (NADO) and the Development District Association of Appalachia, state that, "As of March 2009, 578 separate EDA-backed RLFs (operated by 450 different grantees) were operating in the U.S. These funds managed a combined capital base exceeding $852 million." The report also states that a typical intermediary revolves IRP funds three times over the life of the 30 year loan to an IRP lender which means that every dollar in federal funds loaned to an IRP intermediary translates to $3 lending to rural business."

Some states allow public business lenders to apply for Community Development Block Grant funding to use as match for their loan fund start-up/recapitalization applications. In Missouri, although this is an eligible activity, most grant applications for matching funds are not competitive. These projects must compete with grants applications for basic infrastructure needs in communities, which often take precedence.

State and local governments also use one or a combination of the following to capitalize an RLF: tax set-asides, general obligation bonds, direct appropriations from the state legislature, annual dues from participating counties or municipalities, and funds directed from the state lottery.

Again using the Meramec Regional Development Corporation as an example, it is organized as a not-for-profit under the laws of the State of Missouri with its registered office located at the Meramec Regional Planning Commission. On July 13, 1985, MRDC became a 501(c) 3 nonprofit under IRS Code. MRDC is governed by a 25-member board of directors that includes representatives from the following four groups: 1) Local Government; 2) Private Sector Lending Institutions; 3) Community Organizations; and 4) Small Businesses. The executive committee—including all officers, two at-large directors, and the MRPC at-large member representing finance—also serves as the loan review committee, and the bylaws require that at least one of these members have experience in commercial lending. Currently, the board mix is eleven from finance, nine from business, two from government and one from community organizations.

The MRDC Directors are appointed by the presiding commissioners of the eight member counties served by the Meramec Regional Planning Commission and approved and appointed by the MRPC board.

Proposed Solution and Actions

- A state set-aside is established.
- Applicants apply for matching funds, indicating how the match is to be used.
- If primary and matching funds applications are approved, funds are comingled into one loan fund and are under the guidelines/restrictions of the primary lending agency.
- Reporting requirements would be quarterly reports similar to those submitted to the primary funding agency.

Recently, the Missouri Development Finance Board established a microloan program of $2 million and solicited proposals for professional services to implement, administer, and manage the program. Although this may have been an effective program as proposed, it appeared that it was “reinventing the wheel,” as so many of these loan fund structures are already in place. A more cost-effective use of the funding would have been to allow existing public business loan funds to access the funding, use it to match additional federal dollars, and loan the money to the businesses.

Resources Necessary for Success

Federal programs are available and infrastructure is in place to make loans. However, currently there is not a vehicle in place to access matching funds.

- Funding set-aside - $2M
- Review team for applications
- Reporting system and personnel

Immediate and Long Range Benefit & Performance Measurement

Immediate benefits include bringing in more federal money to Missouri, creating a resource for funding agencies to make application for matching funds. This, in turn, will result in new and recapitalized revolving loan funds that can be accessed by small businesses. Having these funding sources available, will induce skeptical bankers to invest in projects for which they may not want to assume total risk.

Assuming a $2 million set-aside and based upon current results of public business loan funds, it is anticipated that this access to capital will result in a return of $6 million to $8 million in loans to small businesses across Missouri. This, in turn, could generate around $28-30 million in private investment for the state, and result in 1,400 jobs.